April 21, 2008

AGENDA ITEM 4

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I.   SUBJECT: Revision of Policy on Asset Allocation Strategy

II.   PROGRAM: Total Fund

III. RECOMMENDATION: Recommend to the Investment Committee approval of
                              the revised Statement of Investment Policy for Asset
                              Allocation Strategy

IV.   ANALYSIS:

BACKGROUND

The Asset Allocation Policy provides the framework for establishing the asset
allocation Policy mix and its implementation. The Asset Allocation Policy was
last amended September 2007. At that time, Staff indicated that an amended
Policy would be presented to include active asset allocation.

The Committee selects asset class targets and ranges following a triennial Asset
Liability Management (ALM) Workshop. Most recently, in December 2007, the
Committee adopted new asset class targets and ranges, and these decisions are
incorporated in the proposed Policy. The target allocations represent the
expected long-term strategic allocations, and are the weightings used to
calculate the CalPERS total fund policy return. Staff is responsible for managing
asset class allocations within this framework established by the Committee,
within Policy guidelines.

In implementing an asset allocation Policy with targets and ranges there could be
two approaches: rebalancing and active asset allocation. In the rebalancing
approach the actual allocations are allowed to drift as a result of market moves
and a rebalancing action is taken according to set procedures when the limits are
reached. In the active allocation approach any meaningful deviation from the

target is managed as an active position validated through analysis and views of market outlook, valuations, and expected returns.

The existing Policy primarily stipulates a rebalancing approach with some flexibility for managing the allocations within the ranges. The proposed Policy allows for more flexible and active implementation of the Policy within the ranges within size and risk limits, and removes the requirement for a specific rebalancing action. The proposed Policy also calls for an active risk-based approach using the CalPERS Risk Measurement System.

A consistent theme of the revised Policy is that asset class deviations from Policy weights represent active positions, so that Policy guidelines – including risk management, reporting, and clear delineation of responsibilities – should be similar to those of other types of CalPERS active decisions.

DESCRIPTION AND RATIONALE OF PROPOSED REVISIONS

Asset Class Policy Targets and Ranges

The proposed Policy identifies the target, permissible range, and benchmark of each asset class. With this information included in Policy, any change in these key Program measures must be updated in Policy and approved by the Committee. The proposed inclusion of asset class targets and ranges in Policy results in greater clarity and transparency.

Implementation Framework

Edits to the implementation section of the proposed Policy were guided by the following principles:
- Any deviation between portfolio and benchmark asset class weight represents an active position.
- Permitting asset class allocations to passively drift with relative asset returns is suboptimal from:
  - a risk management perspective since the asset weights could be moved closer to Policy weights at minimal cost at least for publicly traded asset classes;
  - an expected return perspective to the extent that Staff or retained managers have skill in taking active asset class positions.
- Asset class deviations from Policy weights represent active positions resulting in active returns, and thus should be treated the same as all other sources of active returns, with:
  - returns measured and reported to the Committee over various periods;
  - clear accountability and delineation of responsibility with a single CalPERS unit accountable for performance; and

- o risks managed through comprehensive investment guidelines included in Policy.

Treatment of Cash

In accordance with the current Policy, CalPERS cash is routinely "equitized," i.e. converted from cash into equity exposure through the use of futures contracts. The rationale is to generate higher returns, since equities are expected to outperform cash over the long term. This limits the ability to reduce the equity allocation when it is preferable to do so. Accordingly, in order to provide greater flexibility, the proposed Policy states that cash may be retained as cash or be converted to bond or equity exposure.

External Managers

Under the proposed Policy, external managers may be hired to implement active asset allocation strategies within specified tracking error limits. The retention of external managers could enhance Staff skills and expertise over time.

RISK CONSTRAINTS

The proposed Policy includes additional guidelines that constrain risk, as described below:

Tracking Error Targets

Targets are established for total fund tracking error and asset allocation tracking error in order to further delineate and manage risk.

The proposed target forecast tracking error is 1.5% for the total CalPERS fund. The realized tracking error, the actual volatility of benchmark-relative returns, has been around 1% since year 2000. This tracking error results from asset allocation deviations and other active management decisions within asset classes.

The proposed target tracking error is higher at 1.5% because of the December 2007 Committee decision to increase the combined allocation to private equity and real estate by six percentage points and allocate 5% of the total fund to the Inflation-Linked Asset Class. Investments in these asset classes experience greater tracking error than fixed income or public market equity assets. The larger allocations to these investments warrant a higher target tracking error at the total fund level. Staff expects a corresponding increase in total fund excess returns.

The proposed Policy also includes a target tracking error of 0.75% for the active asset allocation program. This return, like other CalPERS active returns, is reported by Wilshire on its quarterly reports. The proposed value of 0.75% was

based on a simulation finding that a 5 percentage point over- or underweight to global equities would have resulted in an annualized tracking error of 0.70%.

For both types of tracking errors, Staff will evaluate forecast values against subsequent realized values over rolling three-year periods.

Derivatives

Derivatives are permitted to effect asset class allocations under both the current and proposed Policy, but the proposed Policy includes additional constraints to minimize associated risks. The proposed Policy limits the exposure to counterparties on non-exchange traded positions and establishes counterparty credit quality and regulatory standards. These expanded risk constraints on derivatives are similar to those recently adopted for the Inflation-Linked Asset Class Commodities Program.

Leverage

Leverage is prohibited under both the present and proposed Policy. Leverage is defined in the proposed Policy as asset class leverage, an instance of aggregate exposures across all asset classes of more than 100%. For instance, derivatives may not be used to obtain equity or bond exposure exceeding the market value of the available cash.

V.   STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

There are no material costs associated with this agenda item.

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